Nunnenkamp, Peter

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# Boom, bust, recovery - what next in private capital flows to emerging markets?

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# Boom, Bust, Recovery — What Next in Private Capital Flows to Emerging Markets?

by Peter Nunnenkamp

CONTENTS


- International capital markets are far from functioning perfectly. During the last decade, they overshot both ways: The earlier boom of private capital flows to emerging market economies (EMEs) turned out to be the prelude to the drama of seriously impaired access to foreign capital in the late 1990s. Current concerns are that the next boom-and-bust cycle is in the making, after EMEs have been surprisingly quick in returning to international capital markets.
- Capital market failures notwithstanding, it is hypocritical to blame foreign investors for having caused financial crises. Recent crisis episodes do not support the view that pure contagion has affected EMEs with prudent macroeconomic policies and sound financial sectors. Economic fundamentals do matter still. However, increased international capital mobility implies that foreign (and domestic!) investors react more quickly and drastically to any news, be it bad or good news.
- Domestic policy failures underlying recent financial crises differed considerably. Brazil experienced a conventional currency crisis, caused by inconsistent macroeconomic policies. Korea was characterized by structural weaknesses such as a highly leveraged corporate sector and fragile financial institutions, and by a policy-induced composition of external financing that rendered the country extremely vulnerable to changing expectations of foreign investors.
- A differentiated analysis of international capital markets is required in order to assess the role of private foreign capital in financing EMEs on a sustainable basis. The reaction to financial crises differed between major types of foreign investors. Notably foreign direct investment has proven to be fairly stable. Hence, the structure of capital inflows matters for the sustainability of external financing.
- It depends on exogenous factors beyond the control of EMEs and economic policies pursued in EMEs whether external financing will be provided on a more sustainable basis in the future. As concerns the former, sustainable financing would be encouraged if longer-term engagements by pension funds were supported by deregulation in developed countries, and if reforms in the international financial architecture resulted in prudent bank lending. As concerns the latter, external financing requirements must be kept within reasonable limits, and capital inflows should be restructured towards relatively stable items. The timing and sequencing of capital account liberalization is crucially important to reduce the risk of a sudden reversal in capital flows.
- The good news for EMEs from recent capital market developments is threefold: First, EMEs are not denied access to foreign capital for long even after major economic crises. Second, in contrast to widespread belief, international capital flows are not a zero-sum game, from which only a few large and advanced EMEs can derive benefits. Third, while openness to global capital markets implies hard policy choices, it largely depends on EMEs themselves to which extent they will benefit from capital inflows.


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# I. Introduction

The role of private capital in financing economic development in emerging market economies (EMEs) is under scrutiny. Sustainable external financing depends on smoothly functioning international capital markets. However, sudden shifts from euphoria to panic have shown that the efficiency of international capital markets in allocating worldwide savings to places where they may be utilized most productively cannot be taken for granted. Various EMEs have suffered huge reversals in international capital flows. At the same time, small and less advanced countries are concerned that they will be left on the sidelines in the global competition for foreign capital.

The vagaries of international capital markets are obvious indeed. Increased capital mobility has brought with it financial turbulence and currency crises in Asia, Latin America and Russia. Yet this paper objects the notion that EMEs are the victims of panicking global capital markets in the sense, as a prominent economist put it, that "you may be very healthy but suddenly you can catch pneumonia ... Markets may do something when you have done nothing wrong."[1] We also reject the view that international capital mobility is a zero-sum game, which implies that new competitors for foreign capital would have to detract resources from other EMEs.

The major proposition of this paper is that a differentiated analysis of international capital markets and recent financial crises is required in order to adequately assess the role of private foreign capital in financing economic development in EMEs on a sustainable basis. Differentiation is needed in several respects:

- First, by reviewing recent trends in international capital flows in Section II, it is shown that competition for foreign capital does not mean that some EMEs are crowded out of international capital markets if other EMEs attract rising capital inflows.
- Second, Section II presents a balanced account on capital market failures and compares the behavior of different types of foreign investors.
- Third, two distinct crisis episodes are portrayed in Section III. The comparison of Brazil and Korea reveals that rash generalizations are counterproductive when it comes to explaining financial crises.

Against this backdrop, Sections IV and V evaluate the future prospects of EMEs to sustain foreign capital inflows and draw some policy conclusions. The structure of capital inflows is considered critically important with regard to sustainability. Ultimately, the benefits and costs of capital mobility in the future depend on whether policymakers will implement policies that allow EMEs to tap international capital markets and, at the same time, minimize the risk involved.[2]

# II. Recent Trends in Capital Flows to EMEs

Since the early 1990s, EMEs have witnessed boom and bust in private capital inflows, comprising foreign direct investment (FDI), portfolio investment and other investment flows (including borrowing).[3] All EMEs are expected to attract (net) private capital inflows of about US$71 billion in 2000 (Figure 1). This figure is 37 percent below the private capital inflows reported in 1992. Inflows in 2000 will be a trickle compared to the peak of private capital inflows of US$227 billion in 1995. The subsequent discussion concentrates on the recent ebb of private capital flows to EMEs, after a short evaluation of the boom preceding the Asian financial crisis.

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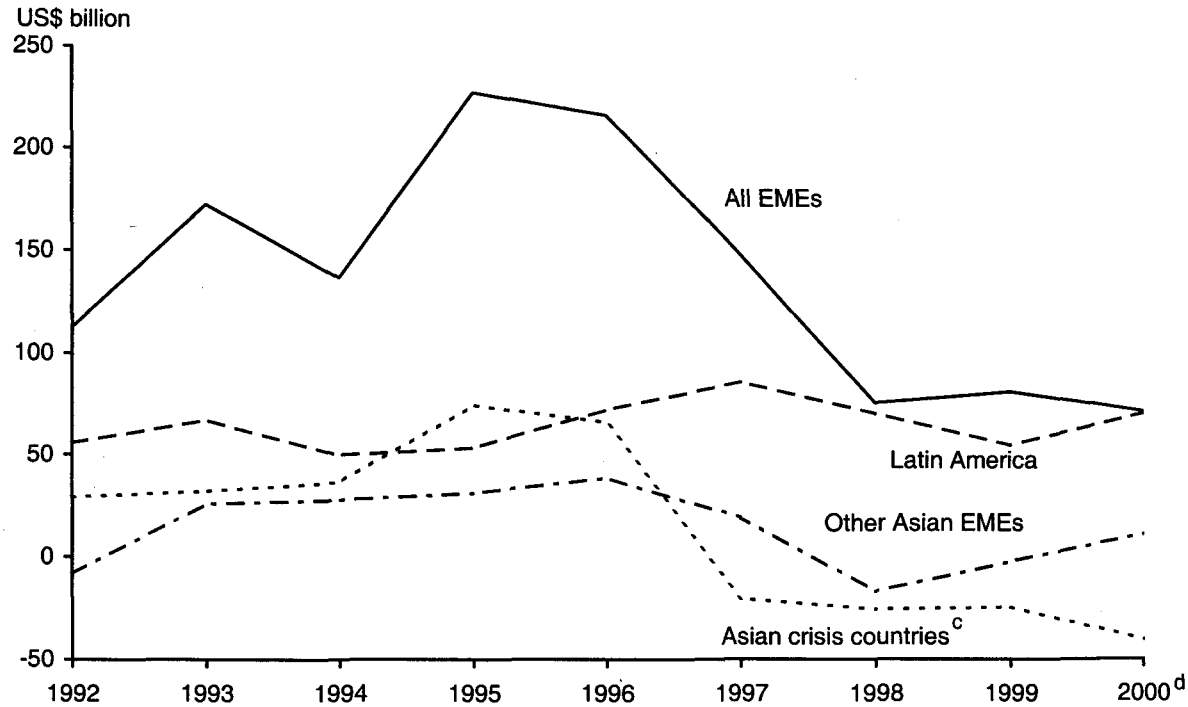
1 Interview of Jagdish Bhagwati with the *Times of India* on December 31, 1997.

2 The need for a new international financial architecture is discussed in Nunnenkamp (2000a).

3 On Asian EMEs, see also Rana (1998).

*Figure 1*: Net Private Capital Flows[a] to Emerging Market Economies[b], 1992–2000




[a]Net direct investment, net portfolio investment, and other long- and short-term net investment flows (including borrowing). — [b]Developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel. — [c]Indonesia, Korea, Malaysia, the Philippines and Thailand. — [d]Forecast.

*Source*: IMF (2000).

## 1. The Boom of Capital Inflows before the Crisis

Booming private capital flows to EMEs in 1992–1996 can be considered the flip side of the sudden retreat of foreign investors when crisis was looming in Asia (e.g. Nunnenkamp 2000b). International capital markets seem to have overshot both ways, with booming inflows having been the prelude to the drama of seriously impaired access of EMEs to international capital markets in the late 1990s.

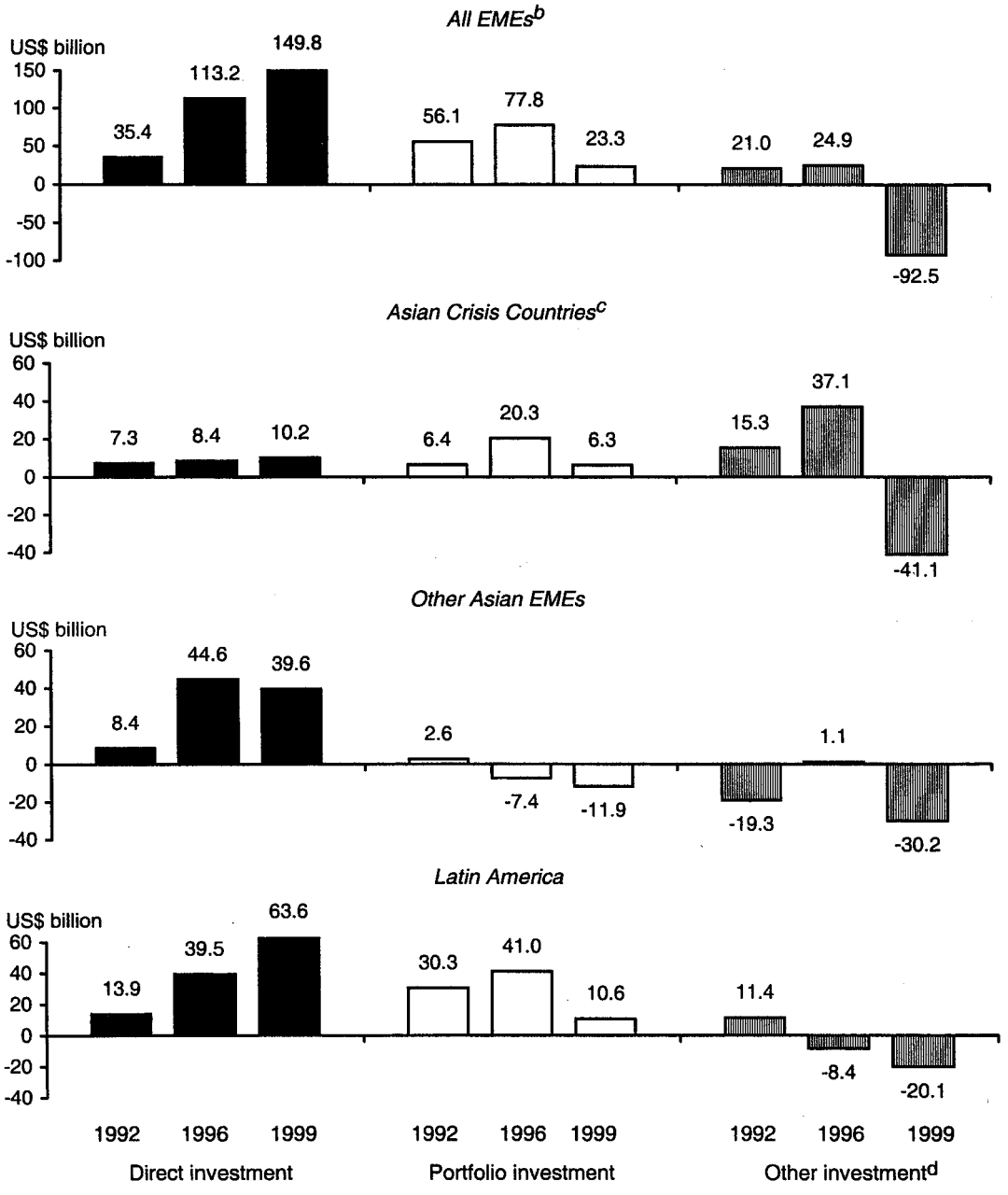
This interpretation requires two qualifications. First, the boom of private capital flows to all EMEs taken together masks significant shifts in the regional distribution of these flows. Second, the structural composition of overall private capital flows changed considerably during the boom phase. Both aspects are crucially important for assessing the sustainability of capital flows to EMEs.

As concerns the structural composition of private capital flows to all EMEs, the most notable feature is that FDI gained relative importance from 1992 to 1996. The share of FDI in overall private capital inflows soared from 31 to 52 percent during the boom phase (see also Figure 2). In absolute terms, FDI flows to all EMEs increased steadily from US$35 billion in 1992 to US$113 billion in 1996. By contrast, portfolio investment and, in particular, other investment (including borrowing) fluctuated heavily prior to the Asian crisis already (IMF 2000: Table 2.2).

The regional distribution of private capital flows reveals a drastic shift towards Asia in 1992–1996, which attracted almost half of private capital flows to all EMEs in 1996 (Figure 3). At the same time, the Latin American share in private capital flows declined from 49 to 33 percent. Figure 3 also in-

dicates that new competitors for foreign capital emerged in Africa and from the group of countries in transition.[4]

*Figure 2*: Major Items of Net Private Capital Flows[a] to Emerging Market Economies, 1992, 1996 and 1999




[a]Net direct investment, net portfolio investment, and other long- and short-term net investment flows (including borrowing). — [b]Developing countries, countries in transition, Korea, Singapore, Taiwan Province of China and Israel. — [c]Indonesia, Korea, Malaysia, the Philippines and Thailand. — [d]Including borrowing.

*Source*: IMF (2000).

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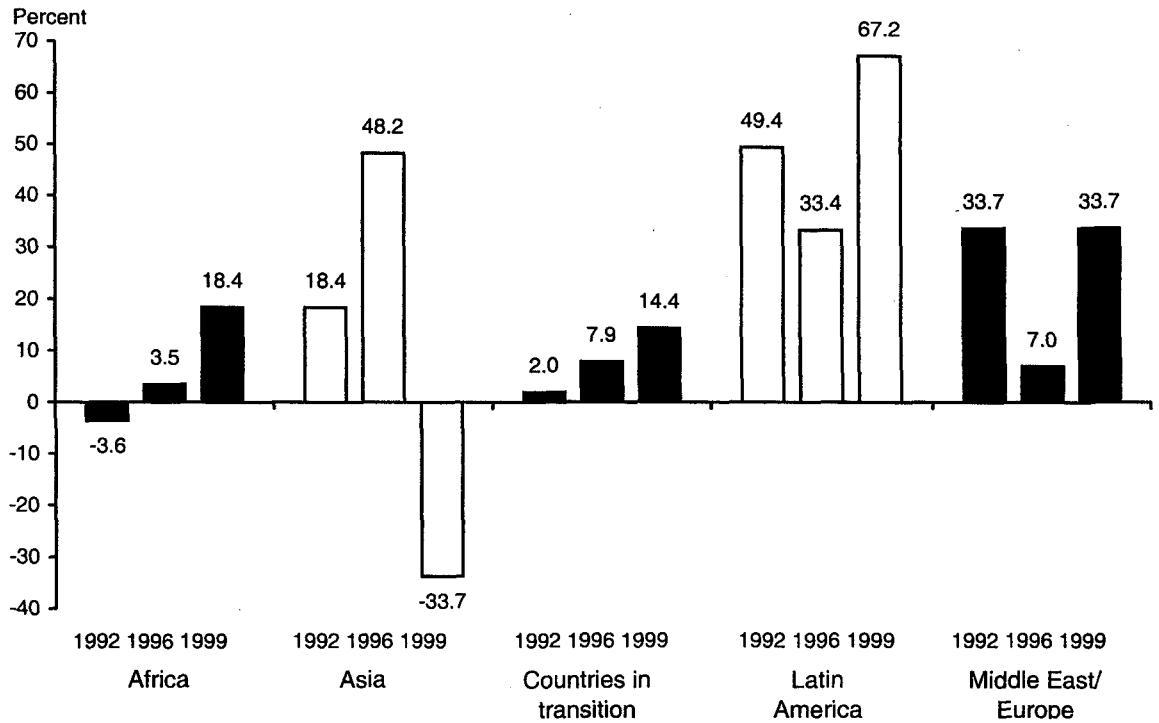
4 Net private capital flows to Africa almost doubled from 1996 to 1999 (IMF 2000: Table 2.2). This increase was mainly due to higher (net) FDI inflows. African host countries with increasing FDI inflows in 1996–1998 included Egypt and Tunisia in North Africa, as well as Angola, Botswana, Ethiopia, Liberia, Madagaskar, Mozambique, Uganda, Zambia and Zimbabwe in Sub-Saharan Africa (UNCTAD 1999: Annex Table B.1).

*Figure 3*: Regional Distribution of Net Private Capital Flows[a] to Emerging Market Economies[b], 1992, 1996 and 1999 (percentage of flows to all EMEs)




[a]Net direct investment, net portfolio investment, and other long- and short-term net investment flows (including borrowing). — [b]Developing countries, countries in transition, Korea, Singapore, Taiwan Province of China and Israel.

*Source*: IMF (2000).

Particularly in Latin America, concerns were widespread that fiercer worldwide competition for foreign capital would divert financial resources away from traditional recipients towards new competitors. Such concerns were largely unfounded, however.[5] When interpreting the shares of particular regions in overall capital flows, it must be taken into account that absolute flows to all EMEs doubled from 1992 to 1996. Hence, a declining share does not necessarily mean that capital inflows decreased in absolute terms. Private capital flows to Latin America were indeed significantly higher in 1996 (US$72 billion) than in 1992 (US$56 billion).[6] FDI flows to Latin America tripled, while other regions, too, attracted rising FDI inflows.

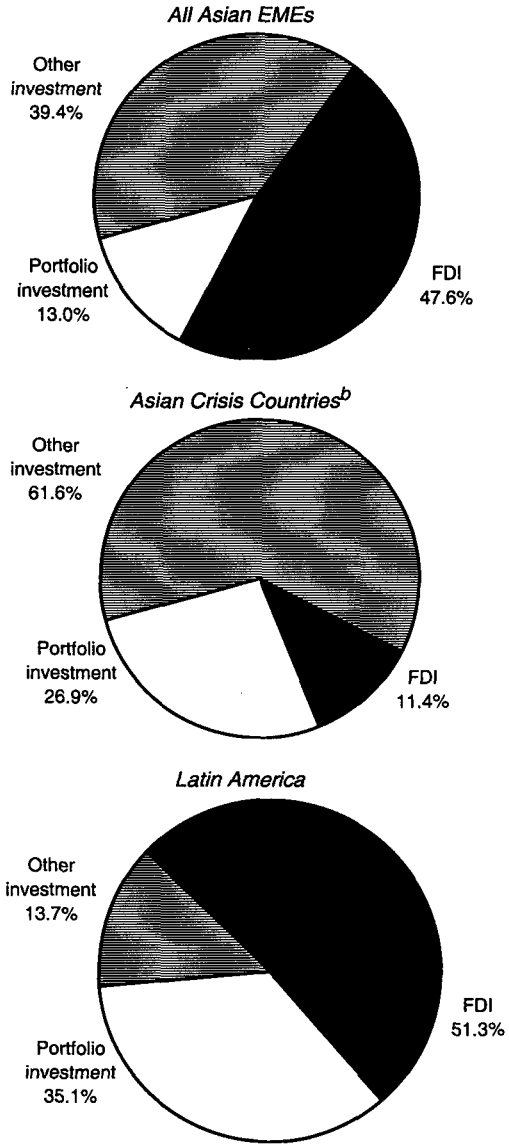
This reveals that international capital flows are far from being a zero-sum game. The emergence of new competitors for foreign capital typically induces foreign investors to grasp additional investment opportunities, without losing sight of investment opportunities offered by traditional recipients of foreign capital. Instead of redistribution of a fixed amount of investment funds, the overall pool of resources to be invested in EMEs expands and international capital mobility tends to increase, when more EMEs open up towards international capital markets.

Furthermore, the development of different items of private capital flows to Asia and Latin America during the boom period provides first clues as to the issue of sustainability. This issue was seriously underrated in Asia until the crisis hit, even though the Mexican experience of 1994/95 had shown

5 This issue is analyzed in more detail in Nunnenkamp (2000c).

6 Private capital flows to Latin America were lower in 1994/95 than in previous years. This temporary decline is to be attributed to the Mexican peso crisis, rather than a redirection of capital flows resulting from the emergence of new competitors in other regions.

*Figure 4*: Structure of Net Private Capital Flows[a] to Emerging Market Economies in Asia and Latin America, 1995/96 (average share in overall private capital inflows)




[a]Net direct investment, net portfolio investment, and other long- and short-term net investment flows (including borrowing). — [b]Indonesia, Korea, Malaysia, the Philippines and Thailand.

*Source*: IMF (2000).

already that the reaction to financial crises differs between major types of foreign investors (IADB and IRELA 1996: 41 ff.). Portfolio investors and bank lenders rushed for the exits so that overall private capital flows to Mexico turned negative in 1995. By contrast, FDI inflows proved to be relatively stable; FDI inflows in 1995 and 1996 were indeed significantly above FDI inflows reported in the pre-crisis year 1993 (Nunnenkamp 1998: 14 f.).

The volatility and sustainability of overall capital inflows thus depends on the structure of external financing. In 1995/96, the structure of external financing varied remarkably between Asia and Latin America; for the group of five Asian crisis countries (Indonesia, Korea, Malaysia, the Philippines and Thailand), the structure of external financing was exceptional prior to the crisis (Figure 4):

- FDI accounted for little more than 10 percent of overall net private capital inflows, compared to more than half of overall private capital flows to Latin America.[7]
- The bulk of external financing of the five Asian crisis countries was in the form of other investment (notably borrowing from foreign banks), whereas other investment contributed just 14 percent to private capital flows to Latin America.

With hindsight, local policymakers and international investors should have been concerned about sustainability during the boom phase exactly in those Asian EMEs that plunged into crisis shortly afterwards.

## 2. The (Irrational?) Behavior of Foreign Investors during the Crisis

The Asian crisis had serious repercussions on international capital mobility in general, and on the external financing of various EMEs in particular. The crisis has also highlighted the deficiencies of international capital markets (Reisen 1999). Two aspects of market failure figure prominently in the ongoing discussion:

- First, the herd behavior of foreign investors is said to have resulted in a collective rush for the exits in Asian crisis countries. The sudden reversal of capital flows is attributed to a coordination failure among foreign investors. Attempts to flee Asian crisis countries as quickly as possible were completely rational from an individual investor's point of view. However, this behavior ran counter to the collective interest of foreign investors. The rush for the exits pushed Asian EMEs deeper into crisis, whereas a standstill of foreign investors could have dampened the crisis.
- Second, crises are widely believed to have spread from one country to another, even though economic fundamentals differed significantly among EMEs. Contagion within Asia and beyond is attributed to the failure of foreign investors to differentiate between various EMEs. Foreign investors are blamed for having put EMEs with and without serious internal imbalances into the same risk basket.

The first aspect, i.e., coordination failure in dealing with the Asian crisis, has important implications for reforming the international financial architecture, an issue which is discussed in a separate paper (Nunnenkamp 2000a). In the context of this paper, it is noteworthy that capital market developments after the outbreak of the Asian crisis confirm what was to be observed during the previous crisis in Mexico and during the period of booming capital flows to EMEs in 1992–1996. Once again, FDI proved to be stable. FDI flows to the five Asian crisis countries were indeed higher in 1998/99 than in the pre-crisis years 1995/96 (see also Figure 2 above).

Volatility was most pronounced with regard to bank lending. The sudden shift from other investment inflows to other investment outflows amounted to about US$80 billion in 1996/97, i.e., more than 8 percent of the five countries' combined GNP in 1997. In 1997–1999, these countries suffered accumulated other investment outflows of US$113 billion. Many portfolio investors, too, rushed for the exits, but the consequences were less severe for the five crisis countries: Compared to an annual average of US$19 billion in the pre-crisis years 1995/96, net portfolio investment inflows declined to an annual average of US$4.4 billion in 1997–1999 (IMF 2000: Table 2.2). This supports the view that portfolio investment comprises relatively stable elements such as investment by pension funds and life insurance companies, whereas volatility in portfolio investment is mainly due to the short-term profit

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7 Note also that FDI flows to Asian EMEs other than the five crisis countries exceeded overall private capital flows to these countries in 1995/96; both portfolio investment and other investment was negative for other Asian EMEs in 1995/96 (IMF 2000: Table 2.2).

orientation of managed investment funds (country funds and mutual funds) (Langhammer and Schweickert 1995: 22; Griffith-Jones and Cailloux 1999).

The second aspect of market failure, i.e., contagion, is more controversial. Interest-rate spreads are a frequently used indicator of contagion. After the outbreak of the Asian crisis, "secondary market spreads increased dramatically ... Countries in all regions were affected ... By the end of December, however, there were signs that investors were differentiating more carefully among developing country borrowers" (World Bank 1998: 14). Investors reacted still more strongly to the Russian crisis, which was rather surprising in view of weak trade linkages of most Latin American and Asian EMEs with Russia. Spreads skyrocketed with the Russian debt moratorium of August 1998 (see also Fernández-Arias and Hausmann 2000b: 26 ff.). While some EMEs (particularly in Latin America) were affected more than others, the variation of spreads across EMEs fell sharply: "Investors appeared to retreat across a broad front; ... countries were affected by pure contagion" (World Bank 1999a: 28).

Overall evidence on interest-rate spreads in recent years suggests that international capital markets sometimes failed to differentiate between higher-risk EMEs and lower-risk EMEs, whereas they did differentiate at other times. For instance, there was a sharp increase in the cross-country variation of spreads from May 1997 to August 1998 (World Bank 1999a: 28). Likewise, the most recent narrowing of spreads on external debt of EMEs "masks considerable regional differences, ..., evidence of increasing investor differentiation among emerging markets" (IMF 2000: 59).

Another indicator of contagion relates to the accessibility of international capital markets at times of a crisis, rather than the terms at which these markets may be accessed. If pure contagion had been prevalent during the Asian crisis, essentially all EMEs should have been denied access to international capital markets. However, empirical evidence on the amount of capital raised in international financial markets by various EMEs is as ambiguous as the evidence on interest-rate spreads:

- The change in portfolio investment flows from 1996 to 1998 reveals considerable differences among Asian and Latin American EMEs.[8] Portfolio investment turned negative not only in some Asian EMEs immediately affected by the crisis, but also in other Asian EMEs such as India and in Latin American EMEs such as El Salvador and Peru. In some EMEs, portfolio investment inflows remained positive in 1998, but dwindled to less than 10 percent of inflows reported in 1996 (e.g., in Mexico, P.R. China and Thailand). By contrast, inflows in 1998 were only slightly below inflows in 1996 in Argentina, Brazil and Singapore. Access to portfolio investment even improved in some cases, including Guatemala, Uruguay and Bangladesh.
- Similarly, the pattern of borrowing in international capital markets varied considerably among EMEs. Apart from the five Asian crisis countries, other investment flows turned negative from 1996 to 1998 in only four out of 23 Asian and Latin American EMEs (China, Singapore, Brazil and Peru). Other investment flows remained negative in three Latin American EMEs (Costa Rica, Nicaragua and Venezuela). The change in inflows was marginal for Bangladesh and India. Among the remaining 14 EMEs, six EMEs (including Colombia and Sri Lanka) suffered a decline in other investment inflows by 55–75 percent from 1996 to 1998, whereas flows turned positive (e.g., in Mexico) or increased significantly (notably in Argentina and Chile) in eight Latin American EMEs. These diverging developments, particularly in Latin America, contradict the view that international banks refused essentially all EMEs access to credit and ignored country-specific conditions during the Asian crisis.

All in all, the evidence on market failure is mixed. International capital markets are far from functioning perfectly. Major elements of private capital flows were extremely volatile because of the herd behavior of foreign investors. FDI is an important exception in this respect, however. At least temporarily, access to international capital markets became more expensive also for EMEs with relatively

8 The subsequent statistical information is from IMF (var. issues).

strong economic fundamentals and with weak economic links to the countries hit by financial crisis. Yet, pure contagion was not ubiquitous. Bank lending and portfolio investment did not dry up in all EMEs. Several EMEs regained access to international capital markets exactly when large parts of Asia were in crisis. True, "there was ample room for the mood of expectations in the financial sphere to shape fundamentals" (Fernández-Arias and Hausmann 2000b: 27); but it is an exaggeration to argue that EMEs with strong fundamentals suddenly collapsed as "the international financial system was too moody to be relied upon" (ibid.). The evidence suggests that economic fundamentals do matter still. At the same time, domestic policy failures tend to have more serious consequences under conditions of increased capital mobility, as the following short account of recent crises in Brazil and Korea reveals.

## III. Two Distinct Crisis Episodes: Brazil and Korea

In the second half of the 1990s, we witnessed a series of currency and financial crises in Asia, Latin America and Russia. At the same time, international capital markets became increasingly integrated due to significant advances in information and communication technology. This coincidence has led many to conclude that globalized financial markets were the cause of crises. However, the notion of globalization crises seriously underrates the country-specific determinants of financial turbulence.

This is most evident in the case of Brazil, whose currency, the real, collapsed in January 1999.[9] Brazil had been the weak link in Latin America since the outbreak of the Asian crisis. The real was attacked for the first time in October 1997. Brazil was affected for the second time, when Russia suspended debt-service payments in August 1998.[10] The irony is that the real fell only in early 1999, shortly after the IMF had agreed on financial support in the order of US$42 billion. IMF support was explicitly designed to preempt speculative activity against the real (EIU 1998: 21).

The IMF was confident that the peg of the real to the US dollar was sustainable. By contrast, various economists and financial market analysts considered the real to be overvalued by 20–40 percent (e.g., Sachs 1999; Dornbusch 1999). Therefore, it is highly controversial to argue, as reportedly done by the president of the Inter-American Development Bank, Enrique Iglesias (*Handelsblatt*, January 28, 1999), that the Brazilian crisis simply reflected contagion and was not caused by misguided economic policies. The opposite view maintains that "it is all homemade, just as Mexico at the time, with an overvalued exchange rate and a huge budget deficit, vast short-term foreign obligations and an explosive indexed domestic debt" (Dornbusch 1999: 1).

Figure 5 presents some relevant facts in support of the latter view. The real appreciated significantly in real terms in 1994. In subsequent years, further real appreciation was prevented as the so-called Plano Real of 1994 succeeded in fighting inflation. Nevertheless, the current account deficit widened. Fiscal adjustment was delayed; the public sector deficit doubled from 4 percent of GDP in 1996 to 8 percent of GDP in 1998. It was only after the currency crash that the Brazilian Congress became inclined to agree to fiscal austerity measures (*Financial Times*, January 22, 1999).[11]

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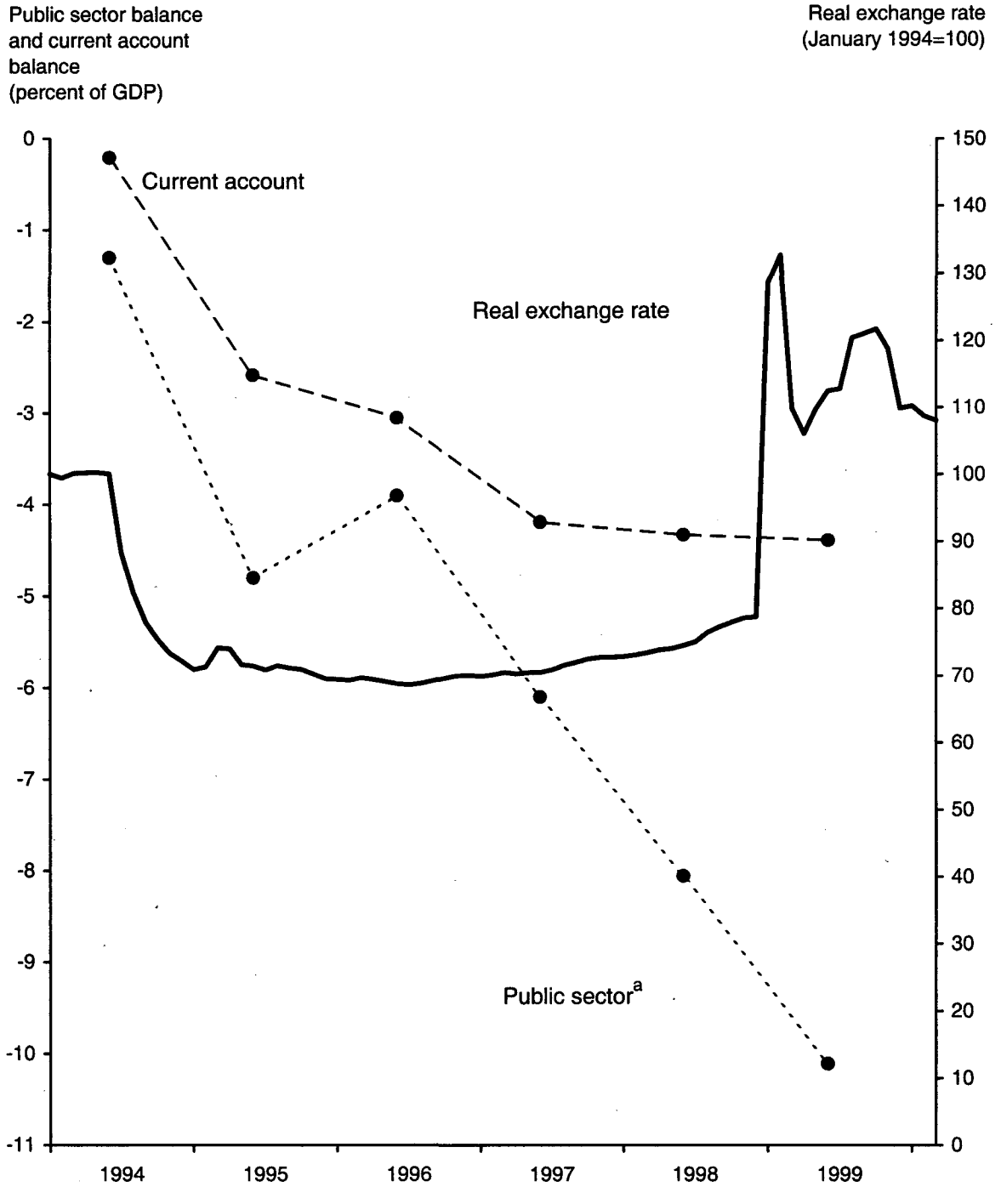
9 The subsequent paragraphs draw on Nunnenkamp (1999).

10 International reserves of Brazil declined by some 20 percent within a few days, and Brazilian debt was downgraded by Moody's (*The Economist*, September 12, 1998: 59).

11 On recent fiscal policy trends in Brazil, see, e.g., IMF (2000: 67 ff.). The primary balance of the consolidated public sector swung into a surplus of about 3 percent of GDP in 1999, as a result of tight expenditure controls and revenue-enhancing measures. Yet, with interest payments soaring, the nominal deficit rose to about 10 percent of GDP (Figure 5).

*Figure 5*: Brazil: Public Sector Balance, Current Account Balance and Real Exchange Rate, 1994–1999




[a]1994–1996: operational deficit, which discounts the inflation rate; 1997–1999: nominal deficit; 1999: January–November.

*Source*: IMF (var. issues); EIU (var. issues).

This suggests that Brazil experienced a fairly conventional currency crisis (see also Saqib 1999). The episode fits easily into first-generation crisis models, developed by Krugman (1979) and Flood

and Garber (1984), well before the globalization of international capital markets became a buzzword. Accordingly, inconsistent domestic economic policies, in particular the combination of a pegged exchange rate with fiscal and monetary laxity, invite speculative currency attacks. The devaluation expected by speculators amounts to a self-fulfilling prophecy with dwindling international reserves of the country under attack. While domestic policy failure caused the Brazilian crisis, contagion from financial turbulence in Asia and Russia may well have been the trigger.[12] However, the case of Brazil does not support Bhagwati's notion, referred to in the Introduction, that "markets may do something when you have done nothing wrong."

At first glance, Korea provides a more plausible case of pure contagion and having fallen victim to panicking international capital markets. In contrast to Brazil, Korea was widely praised for strong macroeconomic fundamentals until the outbreak of financial turbulence.[13] Moreover, "Korea is both far away from Southeast Asia — with minor direct economic linkages — and structurally quite different" (Krugman 1998b). With hindsight, however, several structural weaknesses and policy induced distortions have been identified as internal causes of the crisis:

- It largely escaped public attention that "Korea was characterized by a deteriorating financial situation in the financial and corporate sector well prior to the final attack on the won in October 1997" (Berg 1999: 50). Korean firms were highly leveraged, and profit rates "were already dangerously low by 1996" (Berg 1999: 14; see also Kim 1999). Six of the largest 30 *chaebol* went bankrupt from mid-1996 to mid-1997. Nonperforming loans tripled to 7.5 percent of GDP from late 1996 to September 1997.
- Likewise, the moral hazard underlying the deteriorating financial situation was ignored until recently (Krugman 1998a, 1998b). Korean enterprises undertook "excessive investment ... in the midst of fierce international competition" (Kim 1999: 464). Financial institutions did not carefully assess the business performance of their corporate clients. Both, enterprises and financial institutions followed government directions. According to Borensztein and Lee (1999), credits were systematically allocated to sectors with relatively poor economic performance. Lenders felt insured by the government, at least implicitly, and "never worried about their own collapse" (Kim 1999: 465). However, implicit guarantees proved worthless when it turned out that honoring them would be too costly for the government (Krugman 1998b).[14]
- The structure of Korea's external financing rendered the country extremely vulnerable to changing expectations of foreign investors. In 1996/97, debt-related flows accounted for 73 percent of total long-term net resource inflows; the share of FDI was just 14 percent (World Bank 1999b: 308). More importantly still, short-term external debt outstanding at end-1996 exceeded Korea's international reserves by a factor of 3.4 (Berg 1999: 15). Hence, the won could not be defended when the peg to the US dollar was increasingly questioned in the light of lower export growth, deteriorating terms of trade, and the rise of the US dollar vis-à-vis the yen (Ministry of Finance and Economy 1999; Diehl and Schweickert 1998). Excessive reliance on short-term debt was largely because the Korean government lifted restrictions on short-term capital inflows in the early 1990s, but kept limits on long-term investment (notably on FDI).

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12 Fraga (2000: 16), the current governor of the Central Bank of Brazil, argues: "The background to Brazil's financial crisis in early 1999 included both fiscal and balance of payments weaknesses ... Then, as often happens to vulnerable countries, an economic crisis erupted: after Russia defaulted on its debt in August, capital flows to Brazil came to a halt."

13 The budget of the central government was in surplus in 1993–1996. The current account deficit remained small until 1995 (0.9 percent of GDP, on average, in 1993–1995), soared to 4.7 percent of GDP in 1996 and declined to 1.8 percent of GDP in 1997 (World Bank 2000).

14 According to the Korean Ministry of Finance and Economy (1999: 2), "the bankruptcies of conglomerates [in 1997] were interpreted as a sign that the government would no longer provide its implicit guarantees, further eroding investor confidence."

All this suggests that the internal problems underlying the crises differed considerably between Brazil and Korea. Yet, domestic policy failures are obvious in both cases. It is thus somewhat hypocritical to blame foreign investors for having caused the crises. This is not to ignore that foreign investors rushing for the exits aggravated the consequences of crises. The sudden reversal of capital flows amplified the downturn of stock markets and the fall of the won and the real when these were floated (Figure 6). The overshooting of exchange rates[15] was not prevented by huge financial rescue packages orchestrated by the IMF.

In other words, Brazil and Korea do not provide evidence to the effect that the globalization of financial markets renders crises likely even in EMEs characterized by prudent macroeconomic policies and sound financial sectors. Rather, increased international capital mobility allows foreign (and domestic!) investors to react more quickly and drastically to any news, be it bad or good news. Interpreted this way, increased capital mobility may also help explain economic developments in Korea since late 1997 and in Brazil since early 1999.

The won has recovered since early 1998 from its sharp devaluation, while the Korean stockmarket declined until October 1998 (Figure 6). Korea's GDP shrank by about 6 percent in real terms in 1998. Korea suffered the vicious circle which sets in as soon as a major bubble bursts (Krugman 1998a; 1998b): Asset prices declined when nervous investors began to pull their money out of banks. Foreign investors fleeing the country weakened the won. The decline in asset prices and the weak currency added to the fragility of financial intermediaries. Faltering banks sent another blow to asset prices so that investors fled all the faster.

However, Korea has also become the poster country for recovery from crisis. Real GDP increased by almost 11 percent in 1999. Korea's output is now above pre-crisis levels (*The Economist*, April 15, 2000: 82). Stock markets rallied in 1999. Korea returned to private capital markets as early as April 1998 with a — heavily oversubscribed — US$4 billion bond issue (denominated in US dollar) (Berg 1999: 23). International rating agencies upgraded Korea's sovereign credit rating to investment grade by April 1999 (Ministry of Finance and Economy 1999: 13). Portfolio investment and FDI picked up. Foreign equity participation in the financial sector was an additional source of capital inflows (IMF 2000: 78). Unlike the early 1990s, recent capital flows to Korea have been mostly non-debt-creating. The maturity profile of its external debt has improved significantly, with short-term liabilities being redeemed. International reserves of Korea increased almost tenfold from end-1997 to March 2000.

All this indicates that the reaction of foreign investors to good news was as pronounced as their earlier reaction to bad news. Korea is widely considered "the star performer" among Asian EMEs with regard to reforming the financial sector: "The country has made a huge effort to strengthen and diversify its financial system. Banks have been recapitalised and non-performing loans sold and restructured. There has been a widespread reduction in leverage. ... South Korea's nascent bond market is growing fast" (*The Economist*, April 15, 2000: 83).

While Korea has recovered more quickly than expected from deep recession, the Brazilian economy has proved to be fairly robust after the outbreak of the crisis in January 1999. Growth forecasts of early 1999, according to which Brazil's GDP was expected to decline by some 5 percent in real terms (Nunnenkamp 1999: Table 1), turned out to be wide of the mark; GDP actually expanded modestly by 0.8 percent in 1999. The forecast for 2000 is about 4 percent (EIU 2000: 7).

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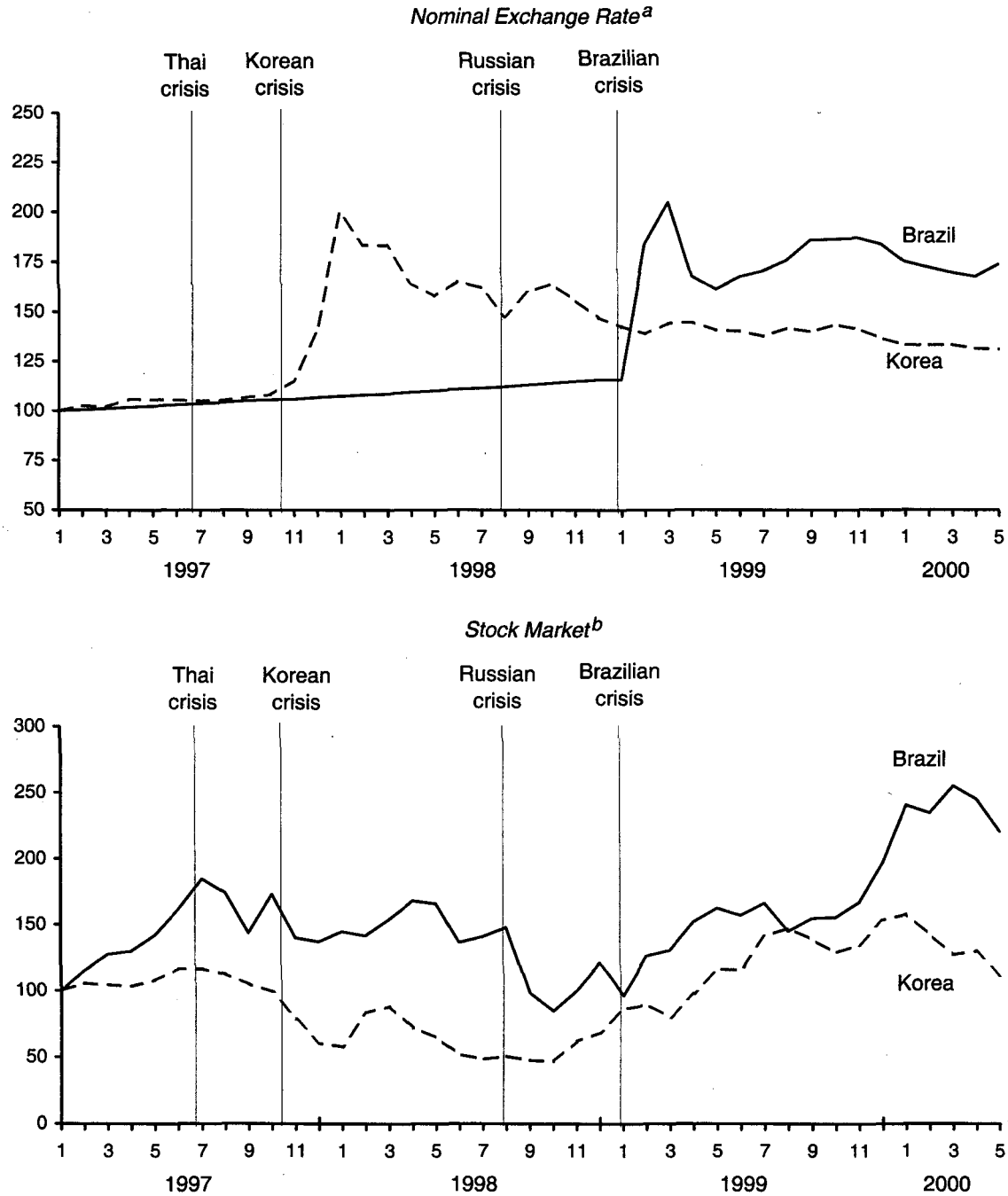
15 Berg (1999: 40) argues on Asia: "The evaluation of appropriate equilibrium exchange rates (is) a particularly difficult exercise. Nonetheless, most observers have concluded that devaluations went well beyond any degree justified by long-run fundamentals. The substantial appreciations observed in 1998 for some countries, particularly for Thailand and Korea, are consistent with this view."

*Figure 6*: Brazil and Korea: Nominal Exchange Rates and Stockmarkets, 1997–2000 (January 1997=100)




[a]National currency vis-à-vis US dollar.— [b]In national currency.

*Source*: Datastream.

An important reason for the fact that Brazil weathered its crisis well is that banks were in relatively good shape. In contrast to Asia, Latin America avoided generalized financial distress in the banking and corporate sectors (IMF 2000: 70 ff.). Banks and enterprises in Brazil had largely hedged the risk of devaluation, and the country had strengthened prudential regulations and supervision. Hence, the financial sector was little affected by the currency crisis in early 1999.

# IV. External Financing of EMEs in the Future

Recent capital market developments suggest that one should not put too much confidence in forecasts on the EMEs' future access to private foreign capital. Most analysts underestimated the drastic reaction of capital markets to crisis, and they were also caught by surprise when crisis-ridden EMEs returned fairly quickly to international capital markets.[16] In December 1998, Rana (1998: 11 f.) considered the medium-term prospects for private capital flows to Asian EMEs "not very encouraging," he continued: "Stability and recovery of international private capital flows ... is still in the distant future." In early 2000, the concern rather was whether the impressive recovery of various EMEs involves "the risk of a new excessive rush into emerging markets" (*The Economist*, April 15, 2000: 84).[17]

Short-term forecasts presented by the IMF (2000: 62) and the Institute of International Finance (IIF) (reported in *The Economist*, April 15, 2000: 82 ff.) differ in some respects, while going together in other respects:

- According to the IMF, net private capital flows to all EMEs in 2000 will remain somewhat below inflows reported in 1998 and 1999. The IMF expects net private capital inflows to pick up considerably in 2001. By contrast, IIF projects net private capital flows to EMEs to increase by some 30 percent in 2000. The forecasts have in common, however, that increased inflows in the near future will remain substantially below record inflows in pre-crisis years.
- Even though absolute numbers on specific elements of private capital flows differ considerably, equity investment, notably FDI, is expected by both institutions to be by far the most important source of external finance for EMEs in coming years. The two forecasts are also consistent in that reduced bank lending to EMEs in general, and to Asian EMEs in particular, will result in further net outflows of debt-related capital in the short run.

For assessing the future prospects of EMEs to attract foreign capital on a sustainable basis, various factors have to be taken into account. Long-run trends indicate that international capital mobility is on the rise (Gundlach and Nunnenkamp 1997: 5 f.). Following Feldstein and Horioka (1980), perfect international capital mobility implies that domestic saving rates are uncorrelated with domestic investment rates. As it stands, international capital mobility is still far from being perfect. However, the correlation between domestic saving and investment rates, calculated for a sample of OECD countries, has weakened considerably since the 1980s. This trend is likely to persist in the future with more countries liberalizing their trade and financial regimes, further advances in information and communication technology reducing transaction costs, and more enterprises globalizing their production strategies. In the longer run, this would imply that higher current account deficits can be financed.

The critical question is to which extent EMEs will benefit from increased international capital mobility. The favorable response of foreign investors to improving economic conditions, e.g., in Korea and Brazil (Section III), suggests that EMEs will not be denied access to international capital markets for long even after major economic crises. It is open to debate, however, whether external financing will be provided on a more sustainable basis in the future than in the past. The risk of further boom-and-bust cycles largely depends on the EMEs themselves, but some factors are clearly beyond their control. Exogenous factors include the following:

- In the short run, "an external shock, such as a sharp fall on Wall Street, could upset confidence" (*The Economist*, April 15, 2000: 84). The IMF (2000: 63) argues: "Unfavorable developments in

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16 In this context, it may be noted that the reactive approach of major sovereign rating agencies frequently intensified boom-and-bust cycles (Reisen and von Maltzan 1999).

17 The Asian Development Bank (2000: 7) argued in early 2000: "Just as the recession tended to be worse than expected when capital was fleeing the region, the recovery now is coming faster than expected by most observers."

the advanced economies, in particular higher-than-projected interest rate hikes or a sharper slowdown in the United States, could harm the prospects for emerging market economies for attracting inflows or boosting exports." The associated reduction in private capital flows would affect Latin American EMEs in the first place. Latin America remains vulnerable in view of sizable net external financing requirements stemming from large current account deficits and persistently low national saving rates.

- In the longer run, the investment behavior of multinational corporations is relevant for putting external financing on a more sustainable basis. UNCTAD (1996: 97) argues that traditional FDI determinants such as the local market size of host countries are losing in importance, relative to globalization-related FDI determinants such as cost differences between locations, the availability of complementary local factors of production and openness towards world markets. As a consequence, more EMEs may become integrated into the globalization strategies of multinational enterprises. This would improve the chances of smaller and less advanced EMEs to attract FDI, which would help them restructure capital inflows towards less volatile items. In addition, FDI prospects in Asia depend on whether European companies will grasp existing investment opportunities, thus reducing their still existing underrepresentation in the region.[18]
- As concerns portfolio investment, the structure of inflows is critically important. In particular pension funds could potentially provide the longer-term capital needed for sustainable economic development in EMEs (Griffith-Jones and Cailloux 1999: 11 ff.). Demographic developments and the reform of pension systems in major developed countries are expected to result in rapidly expanding pension fund assets (see also Rana 1998: 11). According to the World Bank (1997), pension fund assets in Europe will rise nine-fold over the next 25 years. At present, the foreign exposure of pension funds is restricted in major developed countries. The risk control systems and prudential regulations of some developed countries require that institutional investors hold only investment grade securities. This has fueled volatility, as "a downgrading of a country's credit rating leads to an immediate sell-off of the affected assets and to the closing of new funding" (Reisen 1999: 9). Liberalizing the foreign engagement of pension funds could benefit both recipient and source countries. Deregulation may help reduce the home bias of pension funds and create new opportunities in international diversification for developed country savers. In EMEs, the long-term nature of pension fund engagements would allow for sustainable financing of productive investments and help reduce the volatility of overall capital inflows.
- Future developments in borrowing from international credit markets are fairly difficult to predict. At present, bank lenders are still reluctant to resume lending to EMEs. In the longer run, the behavior of international banks depends on whether the current debate on the reform of the international financial architecture will result in a more reasonable burden sharing should new financial crises arise. Reform proposals aiming at "bailing in" private lenders may soften the boom-and-bust cycles in bank lending observed in recent years (Nunnenkamp 2000a). However, it seems rather unlikely that significant progress will be made in this area of reform, as the banking community, most policymakers in Washington and even some EMEs are strictly opposed to binding rules on private sector involvement in sharing the costs of financial crises.[19] It is thus open to question for how long bank lenders will remain cautious.
- Finally, EMEs should not pin their hopes on substantial inflows of official capital from developed countries. This applies especially to EMEs with higher per capita income. Official development assistance has declined in real terms since the early 1990s, and may continue to do so (Nunnen-

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18 For a detailed assessment of European direct investment in Asia, see European Commission and UNCTAD (1996) and Nunnenkamp (2000b).

19 The argument of EMEs against obligatory burden sharing is that it will render borrowing in international credit markets more expensive (Fernández-Arias and Hausmann 2000a). This argument is not convincing because excessively generous bank lending is widely regarded to have fueled speculative investments prior to the Asian crisis.

kamp 2000b). Moreover, indications are that official development assistance will be directed more strongly towards poverty alleviation in low-income countries in the future. Even at times of crisis, substantial inflows of official capital can no longer be taken for granted by relatively advanced EMEs, in the light of recent criticism raised against huge official rescue packages.

These exogenous factors notwithstanding, future access to international capital markets and the sustainability of capital inflows largely depend on EMEs themselves. The risk is that the surprisingly quick recovery from crisis and renewed capital inflows might slow the momentum for reform, even though "the work of strengthening emerging economies' defenses against new crises is far from over" (*The Economist* 2000: 84; see also IMF 2000). Even in Korea, widely considered the "star performer" among Asian crisis countries, corporate reform has barely begun. In other Asian EMEs, e.g., in Indonesia, the banking system is still extremely weak, as the nonperforming loan problem is far from being resolved. As argued before, EMEs in Latin America remain vulnerable to reversals in market sentiment.

Consequently, the pace of reform needs to be maintained both, in Asia and Latin America, in order to transform economic recovery into robust growth and put external financing on a more sustainable basis. As concerns external financing in the future, the challenge facing EMEs is twofold: (i) External financing requirements must be kept within reasonable limits, and (ii) the structure of capital inflows should be improved where inherently volatile flows dominated overall capital inflows in the past. Major policy choices related to these challenges are discussed in the concluding section.

## V. Critical Policy Choices in EMEs

After recent financial crises, the fundamental question facing EMEs obviously is whether the course of opening up towards world markets should be reversed. Some policymakers and economists have commented upon financial crises as if international capital markets are doing EMEs nothing good (e.g., Wade and Veneroso 1998). This suggests that overshooting is a phenomenon prevailing not only in international capital markets, but also in judgements on the functioning of these markets.

It is highly unlikely that, for example, the Asian crisis countries would have caught up economically with developed countries as quickly as they did over the past decades, if they had remained closed to world goods and capital markets. Various studies have shown that openness is instrumental to catching up in the longer run (e.g., Sachs and Warner 1995; Gundlach 1997). Closing the capital account, in order to avoid falling victim to volatile international capital markets, would amount to shooting in one's own feet. This may explain why "there has been remarkably little interest among emerging economies in capital controls" (*The Economist,* April 15, 2000: 83).

The opportunity costs of closing the capital account would be particularly high in EMEs with low national saving rates. Latin America and South Asia, for example, are in greater need than high-saving East Asia to supplement national savings by foreign capital inflows. But even East Asian EMEs will fare better with renewed capital inflows than without. Especially capital inflows in the form of FDI offer benefits in terms of managerial know-how, easier access to foreign markets and transfers of internationally available technologies, i.e., factors that help overcome the crisis and resume the process of catching up. According to Krugman (1998d: 9), "the mere potential for FDI may act as a stabilizer against the risk of domestic financial panics."

The relevant question is not whether to open up, but how to open up in order to keep the risk involved in capital account liberalization within reasonable limits. In this respect, recent financial crises in Asia and Latin America offer various lessons. *First* of all, EMEs must pursue consistent and credible economic policies. As Krugman (1998c) has shown, capital account liberalization implies

hard policy choices, as free capital flows, exchange-rate stability and monetary policy autonomy constitute an "impossible trinity" (see also Frenkel and Menkhoff 2000: 11 ff.).

The choice is essentially between adopting a regime of flexible exchange rates that allows for autonomous monetary policy, or fixing the exchange rate *definitely* by forgoing autonomous monetary policy and establishing a currency board. It is widely agreed by now that intermediate solutions between these two extremes such as pegged but adjustable exchange rates, which were common in Asia and Latin America until recently, invited speculative attacks (Institute for International Economics 1999). According to Eichengreen (1999), "in a world of high capital mobility, democracies cannot credibly attach priority to the maintenance of pegged exchange rates above all other goals of policy." Against this backdrop, various EMEs shifted towards floating in the past two years, while some EMEs are moving to the other extreme.[20]

*Second*, international capital inflows must not be considered a substitute for raising national investment funds. This has traditionally been the case in many Latin American EMEs (*The Economist* 1995). As indicated above, the challenge for Latin America is to increase national saving rates in order to keep external financing requirements within reasonable limits. Latin American governments may contribute directly to achieving this aim by maintaining the pace of fiscal consolidation. This applies especially to Brazil and Colombia, which reported budget deficits of 10 and 6.4 percent of GDP, respectively, in 1999 (IMF 2000: Table 2.3).

*Third*, as concerns sustainability, the structure of capital inflows matters as much as overall external financing requirements. The recent shift in East Asia from debt-related inflows to equity-related inflows is instrumental to soften renewed boom-and-bust cycles. In this context, a widely held misconception needs to be rectified, namely that FDI is a promising source of external finance for only a few large and fairly advanced EMEs (Nunnenkamp 2000d). True, in absolute terms, FDI flows to all non-OECD countries are concentrated on a small group of EMEs.[21] Relative to the host countries' GDP, however, the evidence reveals that various small and less advanced EMEs proved more attractive to FDI than EMEs that were major recipients in absolute terms.[22] Hence, small and less advanced EMEs are not necessarily on the sidelines in the global competition for FDI. They should grasp the opportunity to improve the structure of external financing by offering favorable investment conditions to foreign direct investors.

*Fourth*, the risk involved in international capital mobility may be reduced by keeping limits on short-term capital inflows until well functioning domestic financial markets ensure an efficient intermediation of capital inflows. Chile is the poster country for discouraging speculation by taxing short-term capital inflows (Rogoff 1999).[23] Even Fischer (1998: 5), First Deputy Managing Director of the IMF, conceded: "A case can be made that countries with weak financial systems should restrict short-term inflows." Yet, few EMEs have applied Chilean-style controls on capital inflows so far. EMEs fear that they would have to pay a much higher premium on long-term capital inflows, or that discouraging short-term inflows would result in a sharp reduction in overall lending by international capital markets (Rogoff 1999).

In contrast to capital inflow controls, the imposition of capital outflow controls by Malaysia in September 1998 was highly controversial. Krugman (1998e) argued that outflow controls may be a better choice than steep rises in interest rates or a sharp depreciation of the exchange rate for a country

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20 For example, Ecuador is dollarising; Argentina maintained its currency board in spite of the major devaluation of the real in Brazil, which is Argentina's major trading partner.

21 In 1997, ten EMEs (in descending order: China, Brazil, Mexico, Singapore, Argentina, Russia, Colombia, Chile, Malaysia and Venezuela) accounted for about 70 percent of FDI flows to all non-OECD countries (World Bank 2000).

22 In Asia, for example, FDI flows to Cambodia and Vietnam amounted to about 7 percent of GDP in 1997, while the corresponding ratio was about 5 percent in China and Malaysia.

23 Chile reduced implicit taxation of short-term capital inflows to zero in September 1998. For a sceptical assessment of the effectiveness of Chile's approach, see Buch et al. (1998).

whose currency is subject to a serious attack. Most economists insisted, however, that the costs of outflow controls outweigh the benefits. Controls tend to invite evasion and corruption and, if strictly applied, may scare off investors for long. Malaysia lifted controls in 1999 and claimed victory (*The Economist,* May 1, 1999: 75). By mid-2000, it is fair to conclude that adverse effects of Malaysia's approach proved to be smaller than many had feared. At the same time, Malaysia's recovery "has not exactly proved the proponents right. For there is a recovery in progress throughout Asia" (Krugman 1999; see also Rogoff 1999). The controls turned out to be largely irrelevant, as the panic was subsiding just when the controls came on (*The Business Times*, Singapore, August 27, 1999, quoting Krugman). When the controls were imposed, the ringgit had already fallen by some 40 percent, so that their effectiveness in preventing a currency collapse has not been tested. Furthermore, the controls formed "only one part of an overall economic regime that is in many ways a model for other emerging markets" (*The Economist,* May 1, 1999: 75).

In summary, the timing and sequencing of capital account liberalization is crucially important for attracting foreign capital inflows on a sustainable basis. EMEs must prepare well for complete capital account liberalization: "They will need to adapt their policies and institutions, particularly their financial systems" (Fischer 1998: 2). Financial institutions must be supervised effectively, prudential standards should be in line with international best practice and must be enforced, and governments must not create expectations that private sector liabilities are guaranteed. The composition of capital inflows requires careful monitoring. In order to avoid excessive reliance on short-term financing, the sequence of capital account liberalization should be the very opposite of Korea's approach in the early 1990s. Restrictions should be lifted for FDI in the first step, while limits may be kept on short-term capital inflows. This is also because precautionary controls on short-term capital inflows appear to be superior to restricting capital outflows in the midst of a crisis.

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